

## The Importance of Average Annual Returns

To help you understand the concept of “Average Annual Returns,” and how important they are in retirement financial planning, consider the following story. You (Tom) walk into a financial planners office (Bob) and tell him that your brother-in-law (Steve), a client of his, suggested that he could help you invest a recent \$100,000 inheritance. After getting to know each other a little better, you decide to become a client. The rest of your conversation might go something like this:

Bob: So, Tom, when do you need your \$100,000 back?

You: I don't know. I wasn't expecting it. I don't need it for anything. I just thought I should invest it.

Bob: I understand. But I do need to have some idea of when you want the money back to be able to help you get it invested.

You: Like I said, I don't know. Does it really matter? I just want to put it away.

Bob: Yes, it does matter. If I don't know when you want it back, I can't determine how long you can stay invested. If I don't know how long you can stay invested, I can't decide how much risk you can afford to take. And if I don't know how much risk you can handle, I can't really do my job.

You: Hmm...

Bob: Let me ask you this....Do you need the money next year—for a new car, or a boat, or a vacation or anything?

You: No.

Bob: Will you be using it in the next five years to buy a cabin, remodel the house, or put a kid through college?

You: No.

Bob: Can you think of any other reason you would need it in the next ten years?

You: No. I'll probably just use it for retirement.

Bob: So you won't need the money for at least ten years? (You are 45 years old.)

You: Nope. Like I said, I'll probably use it for retirement.

Bob: Okay then. We have at least a ten-year investment horizon.

You: Well...I guess so.

*(With a little more discussion, you determine that you are neither overly aggressive nor overly conservative as an investor, so you agree that a blue chip stock fund would be a good fit.)*

Bob: Given everything we've talked about, I think you should invest the money in a large company stock mutual fund, and just let it sit there and grow for the next ten years.

You: Sounds good....you're the expert.

Bob: Alright. I'll take care of it.

*(You finish talking through the details. You get up, you shake hands, you head toward the door, and as you're leaving the office you turn back to ask a simple question.)*

You: By the way....how much will I earn on the investment?

Bob: I suppose somewhere around 9.0 percent.

*(Bob makes this assumption because he knows that blue chip stocks have returned about 10.5 percent on average over the last eighty years, and because he wants you to be on the conservative side of that long-run average. Knowing that you have a ten-year investment horizon gives him confidence that you will be able to ride out the ups and downs in the market and come in relatively close to your agreed-upon expectations.)*

You: Okay. It was good to meet you.

Bob: Likewise Tom. Say hello to Steve the next time you see him.

So—what happens next? The chart below is a hypothetical example of what might take place over the next ten years. The Variable Returns area shows that although annual returns fluctuated substantially from year to year, and never even once hit 9.0 percent, overall that's exactly what you would have earned—because the ten-year pattern of ups and downs is equivalent to earning 9.0 percent each and every year. The Straight-Line Returns area shows clearly that earning 9.0 percent every year would get you to the same ending balance as the fluctuating pattern of Variable Returns.

Year	Variable Returns			Straight-Line Returns		
	Beginning Balance	Rate of Return	Ending Balance	Beginning Balance	Rate of Return	Ending Balance
1	\$100,000	13.00%	\$113,000	\$100,000	9.00%	\$109,000
2	\$113,000	1.00%	\$114,130	\$109,000	9.00%	\$118,810
3	\$114,130	23.00%	\$140,380	\$118,810	9.00%	\$129,503
4	\$140,380	-3.00%	\$136,169	\$129,503	9.00%	\$141,158
5	\$136,169	18.00%	\$160,679	\$141,158	9.00%	\$153,862
6	\$160,679	15.00%	\$184,781	\$153,862	9.00%	\$167,710
7	\$184,781	-5.00%	\$175,542	\$167,710	9.00%	\$182,804
8	\$175,542	18.00%	\$207,139	\$182,804	9.00%	\$199,256
9	\$207,139	2.00%	\$211,282	\$199,256	9.00%	\$217,189
10	\$211,282	12.00%	\$236,636	\$217,189	9.00%	\$236,736
Average Annual Return		9.00%		9.00%		

The question is—how would all of this play out in your ongoing relationship with Bob? Your future conversations, given the variable pattern of returns, might go something like this:

End of Year 1 (Bob calls You.)

Bob: Hi Tom. Did you get the statement I sent last week? We did well this year—we made 13.0 percent.

You: Yes I did. That's terrific. Thanks for checking in.

End of Year 2 (Bob doesn't have to call you, because you call him after receiving your statement.)

You: Hey, what happened this year? Where's our 13.0 percent?

*(You get into a long conversation. First, Bob reminds you that the goal is 9.0 percent, not 13.0 percent. More importantly, he tries to explain that you are not expecting 9.0 percent every year—you are expecting to earn it on average over the whole ten-year period. Unfortunately, this is the first time he explains it to you this way—and his digression about ten-year average annual returns probably sounds more like an excuse than an explanation. But, eventually, you get off the phone—maybe or maybe not understanding what Bob was trying to explain.)*

End of Year 3 (You call Bob again, because you're feeling a little better now.)

You: Well, that's more like it Bob—23.0 percent works for me! Keep up the good work.

*(You get into another long conversation, with Bob trying to convince you that you shouldn't be expecting such outsized returns to occur again in the future. He tries to explain average annual returns again, and this time you may think that he's just trying to hedge on future performance. You are probably beginning to wonder if he knows what the heck he's talking about.)*

End of Year 4 (You really don't want to call Bob—but you know you have to do it.)

*(Somehow you have to figure out a way to break the news to Bob that you are moving your account to another advisor. After all, you probably still think he told you to expect 9.0 percent per year for ten years—and the first four years prove that he doesn't have any idea what he's talking about. Unfortunately, you still may not understand that when Bob said 9.0 percent per year, he meant **9.0 percent per year on average over the whole ten-year period, not 9.0 percent each and every year.** Back at the beginning of your relationship, Bob needed to be sure you understood that while it's reasonable to expect a \$100,000 blue-chip investment to grow to \$236,000 over ten years—since a ten-year average annual return of 9.0 percent is fairly reasonable, there is no way to know what the roller-coaster ride will look like. But with a ten-year investment horizon it shouldn't make any difference—because it's not the pattern that matters, but the overall results. That's the reason he needed to know how long you could stay invested in the first place—because it's the only way he could determine how much time you had to go after reasonable average annual performance.)*

Bottom-line: you may have terminated a relationship with a great advisor—even though the Variable Returns area of the chart shows clearly that you would have actually achieved the 9.0 percent average annual return he told you to expect over the entire ten-year period. But it's

really Bob's fault that you left, because he should have made sure that you understood the idea of average annual returns, which is one of the most important investment concepts of all.

The moral of the story: Make sure your advisors provide the education you need to understand how to manage money properly during retirement. You need trust and understanding to protect yourself against the two biggest obstacles to retirement success—fear and greed.

You can learn more about The Grangaard Strategy® approach to retirement income planning, and educational events being offered in your area, by visiting [www.TheGrangaardStrategy.com](http://www.TheGrangaardStrategy.com). Paul Grangaard can be reached at [paul@pagrangaard.com](mailto:paul@pagrangaard.com) or by telephone at 651-917-0139.

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